CREATING A COMPETITIVE BUSINESS ENVIRONMENT

Prepared for the Business, Labor, and Agriculture Interim Committee
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Introduction

For the past several months, the Business, Labor, and Agriculture Interim Committee (Committee) has investigated the issue of government competition with private vendors. House Bill No. 515 (HB 515), the genesis of the study, also required that the Committee strive to identify government services or programs that could be candidates for privatization. After hearing from many private vendors, the Committee has instructed staff to begin to collect information that will assist the members in creating a process that, if implemented, could serve to address the issues associated with public-private competition and that would allow for the identification of government programs that could be candidates for privatization.

The Committee agreed that while there are examples of unfair competition between government entities and private vendors, an alternative way of approaching the questions raised by HB 515 may be to investigate the issue of service delivery opportunities available to alternative vendors in areas in which a government provider offers services to the public that are similar to services offered by private vendors.

Additionally, by referring to any potential policy recommendations as "creating a competitive business environment", the Committee can incorporate a growing body of literature that suggests that the presence and degree of competition leads to improved service quality and lower service costs. At this point, a caveat is necessary. Managed competition, or public-private competition, seems to be moving in an opposite direction from the original premise of HB 515 and the general concerns of private sector vendors. Under a managed competition scenario, the public sector competes directly with the private sector for the opportunity to provide services. The process assumes and presumably requires that the process to create public-private competition is fair and equitable.

To date, the Committee has not specifically requested information related to managed competition and its potential for resolving the issue at hand. However, after reviewing the principles of managed competition, several components, applied in an alternative fashion, may offer policymakers some additional insight into developing a proposal to encourage greater reliance on private vendors and increase the effectiveness and efficiency of service delivery.

In reviewing the existing law in regard to privatization, the intent of two statutory provisions may offer some guidance to the Committee. Amending the provisions of House Bill No. 64, which was passed during the 1999 legislative session and requires agency program budgets to contain a prioritized base budget reduction plan, could serve as a vehicle for making changes in the manner in which state government provides public services. Title 2, chapter 8, part 3, MCA, governing privatization plan reviews, contains the current statutes related to privatization.

This paper attempts to tie together the numerous discussion points raised during the March Committee meeting and begin the process of recommending policy changes. It also serves as an opportunity to raise questions and spur answers that ensure that the implications of any major policy change are, if not addressed satisfactorily, at least known to policymakers. The Committee chose the following areas to begin the process of developing a model for creating a competitive business environment.

- The cost of providing services, whether by government entities or private vendors, must be established based on a full cost accounting methodology.
- The Committee, with assistance from the Executive Branch, divisions within the Legislative Branch, and private sector vendors, must develop an accounting tool that guides the cost accounting process.
- A process to determine the accuracy of the cost accounting analysis is necessary, and a body to review the process is critical.
- A hearings process is necessary to ensure that the decisions that are made regarding whether a government entity should continue to provide a service in-house can be challenged when appropriate.

The Committee has directed staff to investigate the many issues associated with public-private competition and develop a policy option to create a consistent and stable process for private vendors and state agencies to make service delivery decisions.

Managed Competition

According to several experts, managed competition can be seen as the maturation of the privatization movement and contracting policies adopted by governments during the last decade.[1] At first, governments experienced the benefits of competitive service delivery as a result of privatization. However, according to these experts, privatization is subject to a major theoretical criticism. Privatization proponents assume that private sector service delivery is always less costly and is always of an equal or greater quality than public sector service delivery. For managed competition supporters, their policy recommendation suffers from no such ideological value judgment. They suggest that public-private competition is predicated on the notion that it is not the mode of delivery that leads to improved service quality and cost savings, but the presence and degree of competition.

In order to determine whether Montana would benefit from a managed competition methodology, the development of a level playing field is necessary. This task assumes that the state seeks to formalize a process for determining the best provider of public services rather than making those same decisions on an ad hoc basis. In *Determining a Level Playing Field for Public-Private Competition*, Lawrence Martin writes that there are thirteen major issues. He has further divided those issues into three categories: process issues, costing

[1]Martin, Lawrence L., Determining a Level Playing Field for Public-Private Competition, The PricewaterhouseCoopers Endowment for The Business of Government, 1999.

issues, and contract administration issues. For the purposes of this discussion, contract administration issues will not be included in the description of managed competition.

Process issues refer to the way that government deals with the procurement process. Within this category are four specific issues: the type of competition, the access to consultants, the independent review of public benchmarks, bids, and proposals, and the separation of purchaser and provider functions. Essentially, if the last three issues apply to both public and private entities, a level playing field is apparent. In order for the first issue, the type of competition, to be competitively neutral, the state must employ a parallel process. In other words, a parallel process allows that both the public and private provider are given the same period of time to develop benchmarks, bids, or proposals.

Within the cost category, there are six specific issues. They are:

- Mandated private sector wage scales.
- Mandated private sector employee benefits.
- Minimum cost savings thresholds.
- Cost comparison approach.
- Transition costs.
- Contract administration and monitoring costs.

In this case, if the structure developed to conduct a fair comparison does not demand that the first three issues be required, a level playing field is achieved. If the costs identified by the last two issues are excluded for both the public sector and the private sector, a level playing field occurs. The remaining issue, the approach to comparing costs, offers a twist that challenges the general belief that a fully allocated cost approach results in a situation under which both providers are on equal footing. Martin suggests that the "Texas Approach" is the only cost allocation model that does not benefit either party. The Texas Approach is characterized by accounting for the fully allocated costs, the avoidable costs, and the unavoidable costs. The unavoidable costs are then added to the contractor costs to arrive at a competitively neutral scenario.

Including the managed competition process in the competitive business environment proposal offers the Committee an opportunity to reflect on whether they should try to incorporate the principles espoused by Martin in order to provide the Executive Branch with a clear understanding of the Legislature's policy intentions.

Privatization Plan Review

Title 2, chapter 8, part 3, MCA, established the state's sole provisions governing privatization. These sections provide a process that agencies must follow if they are considering privatizing a specific government program. Section 2-8-301(3), MCA, states that privatization means

contracting with the private sector to provide services normally conducted directly by public employees if the contract displaces five or more employees.

Before an agency may privatize a program, it must prepare a privatization plan for distribution to the public. The Legislative Audit Committee is required to hold a public hearing on the proposed plan and distribute the hearing proceedings and any recommendations that the Committee develops.

The contents of the privatization plan are listed in section 2-8-303, MCA, and include:

- a description of the program;
- detailed budget information listing expenditures for the two most recent fiscal years;
- a list of affected personnel;
- a list of the program's assets and a disposition plan if the program is privatized;
- an estimate of cost savings or additional costs resulting from the privatization of the program compared to the costs of the program conducted in-house;
- an estimate of the impacts that the privatization proposal would have on other state programs, including public assistance, unemployment insurance, personal services budgets, and retirement programs;
- the estimated increases or decreases in costs and quality of goods or services to the public if the program is privatized;
- the estimated changes in individual wages and benefits resulting from the proposed privatization; and
- an explanation and justification for the privatization proposal.

Section 2-8-304, MCA, provides that the Legislative Auditor, in the course of routine audits of state agencies, shall submit to the Legislative Audit Committee any information that the Auditor uncovers that relates to privatizing agency programs or returning to the agency the responsibility for those services currently under contract with the private sector. The section also provides an opportunity for anyone, including the public, to request that the Legislative Audit Committee review services currently under contract that may be more effectively administered by a public agency. Additionally, the Governor's Office of Budget and Program Planning is required to submit a request to the Legislative Audit Committee to conduct a privatization review of programs accounted for in an enterprise fund or an internal service fund.

In any of the incidences established above, the Legislative Audit Committee may review the appropriate information, elicit public comment, and make an appropriate recommendation to the full Legislature.

House Bill No. 64

House Bill No. 64 (HB 64), enacted during the 1999 legislative session, requires that agencies with more than 20 FTE provide a plan to the Governor's Office of Budget and Program Planning for reducing their proposed base budget by 15%. According to a Legislative Fiscal Division staff report entitled *Implementation of HB 64*, there is historical precedence for asking for this type of information. This type of information is required by section 17-7-111(3)(g), MCA. Clearly, codifying this practice serves as a budgeting tool for legislators. It may, however, offer the Legislature both some insights and a vehicle to assess whether certain agency programs are competing with private service providers or whether they should be considered as candidates for privatization. The section requires that the following information be submitted:

- a prioritized list of services that would be eliminated or reduced;
- the savings that would result from the reduction or the elimination of the service identified on the list; and
- the consequences or impacts of the proposed elimination or reduction of each service.

The Legislative Fiscal Division has also developed a recommendation for the Legislative Finance Committee to consider regarding the implementation of the section. The Legislative Fiscal Division suggests that the process for identifying and considering the reduction of services would require the following information to be submitted by the agency (most is specified by 17-7-111(3)(g), MCA):

Form A - a prioritized list of the services that would be eliminated or reduced.

Form B - one completed for each service listed on Form A, and providing:

- a description of the service, including why it can be considered for elimination or reduction;
- the savings that are expected (FTE, personal service costs, operating costs, etc.);
- the consequences or impacts of the proposed elimination or reduction;
- how the impacts to constituents and staff might be mitigated; and
- whether the service is specifically required by statute – yes or no (if yes, providing the statutory cite, and if no, providing the authority under which the services are provided).

All of the information proposed by the Legislative Fiscal Division for inclusion in the implementation of HB 64 represents important components in the Committee's investigation into government competition and privatization. The recommendations also generally mirror the requirements present in the privatization plan review statutes under the authority of the Legislative Audit Division.

With these tools in place, the Committee could consider how its own potential recommendations for remedying unfair competitive practices and creating more opportunity for private vendors to expand their operations would complement existing policies.

Options for Implementing a Competitive Business Environment in Montana

Based on the Committee's preliminary discussion of the results of the government competition survey, the following policy option represents a starting point for draft recommendations. In the following paragraphs, each component is discussed along with a number of considerations that should be addressed to ensure that the full intent of the Committee will be clear.

The outline below represents the highlights of the option of creating a competitive business environment policy.

I. Private preference policy

The first activity would be to establish a private preference policy in law that provides a clear intent to the public and private sectors that it is in the public's best interest that the state endeavor to utilize the private sector for the provision of public services when appropriate following a rigorous review of several factors.

Within the private preference policy is the assessment of the commercial services that, initially, will drive the competitive business environment process. The list of commercial services should be viewed as a tool to determine cases in which the state could, following a review process, choose a private vendor to deliver the services. The list serves an additional purpose in that it also identifies, by virtue of being excluded from the list, those public services that the state believes are required by the public interest to be provided by the government. However, the Legislature should also consider that even though a service may be included on the commercial services list, the function may be inherently governmental.

Initiating this policy would clearly signify and justify the Legislature's intent to reduce or eliminate incidences of unfair government competition and would offer a formal process for making decisions about who provides a service. The formal process removes the uncertainty regarding real or perceived benefits that results from an ad hoc approach.

II. Statutorily create a "competition council"

The second order of business is to create a "competition council" and empower it with clear authority and objectives. The council could take many forms, including:

- appointed solely by the Legislature;
- appointed solely by the Governor; or
- appointed jointly.

The membership, terms of appointment, and where the council should be administratively attached are details the Committee needs to consider.

More importantly, the Committee must decide on the role and responsibilities of the council. The Legislature may authorize the council to review agency activities to determine a list of commercial services, adopt rules implementing the broad policy guidelines requiring the establishment of a full cost accounting model, and make a final decision as to whether services should be conducted by public entities or private providers. If the council is given the authority to make a final decision, the council becomes an inherent function and tool of the Executive Branch.

II b. The Legislature may wish to limit the duties of the council by requiring that the Executive Branch conduct an initial analysis of commercial services and by restricting the council's work to simply reviewing the evidence collected from both public and private providers. The Legislature could require the Executive Branch to conduct the analysis under the same justification used for HB 64. Similarly, the Department of Administration, rather than the council, could be given the authority to adopt rules related to the implementation of a full cost accounting model.

III. Review process

- Full cost accounting requirement
- Request for proposals (RFP)

If a service is on the commercial services list (regardless of who develops the list), the affected agency is directed by the council to simultaneously issue a request for proposals and conduct a cost analysis using the full cost accounting guidelines developed by the Legislature. The RFP document must reflect the same characteristics present in the cost accounting document to allow for a literal line-by-line comparison of the competing proposals.

When both proposals are completed, the council must consider whether, on the basis of cost, the service should be provided in-house or be subject to a privatization option. If choosing one proposal over the other is clearly in the public's interest relative to the actual costs associated with providing the service, the council shall make its decision known to the competing bidders. If the costs are reasonably similar, the council must assess a number of additional factors to

determine whether the service is conducted by an in-house provider or a private sector provider. The factors include but are not limited to the:

- quality of service;
- accountability and responsiveness of the service provider;
- ability to readily define the nature and scope of the service;
- public health, safety and welfare issues;
- legal barriers;
- time or resource constraints; and
- impact on public employees.

These factors represent a broad stroke of considerations that policymakers should outline in a competitive business environment policy. No attempt has been made to assign a quantitative value to the listed factors or include them in a policymaking calculus. The Legislature should expect the decisionmaking body to exercise due diligence when valuing these items and their relationship to the cost analysis.

Following the analysis of the additional factors, if appropriate, the council announces its decision. Three entities should be afforded the ability to request a review of a commercial service: a state agency, a private vendor, or the Legislature by joint resolution.

IV. Administrative hearing

If, following the council's decision, either a private vendor or, potentially, a public employee organization wishes to challenge the decision based on the fact that the council failed to follow the law as written or consider the appropriate evidence, the appellant may employ an administrative hearing process. The hearing process begins with the council and is exhausted with an appearance before the Governor. If the appellant does not receive satisfaction through the administrative hearing process, the option to file a legal action in a district court is available.

V. Final decision and implementation

Depending on the recommendation made by this Committee, the reviewing body may have the authority to either direct an agency to act on the reviewing body's decision or make a recommendation to the full Legislature outlining its reasons for any decision regarding service delivery. As was mentioned earlier, the Legislature may not wish to involve itself in the implementation regarding a decision upholding or modifying the manner in which services are provided. Rather, the Legislature should ensure that the policy statements that are made under the competitive business environment proposal are clear so that the Executive Branch can act with certainty.

Conclusion

The option outlined in this paper offers policymakers an opportunity to address the concerns raised by private vendors and expand the discussion to include the overarching question of the effective and efficient delivery of public services. The Committee should determine what role they envision the Legislature having in the competitive business environment proposal and should create the language and intent necessary to provide adequate direction to state agencies.

Reviewing the managed competition process as envisioned by Lawrence Martin, in *Determining a Level Playing Field for Public-Private Competition*, may assist the Committee in refining the competitive business environment proposal. Also the Privatization Review Plan and the provisions contained within HB 64 require the Executive Branch to follow a specific approach to both in order to identify those services that may be transferred or contracted to alternative providers and to prioritize, from a budgeting perspective, what the core programs or functions are in each agency. Any Committee recommendation should further review these laws to determine whether they can be modified to accomplish the goals established by the completion of the HB 515 study.

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